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E FOR THOMAS PIERCE, WHA FOR WHA/BSC AND WHA/EPSC
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TAGS: EFIN EINV ECON AR
SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL WEEKLY (OCTOBER 27, 2006)

¶1. Provided below is Embassy Buenos Aires' Economic and Financial Review for the week ending October 27, 2006. The unclassified email version of this report includes tables and

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charts tracking Argentine economic developments. Contact EconOff Chris Landberg at landbergca@state.gov to be included on the email recipient list.

Weekly Highlights

--Buenos Aires Province successfully launches $475 million bond issue
--Argentine Congress may extend Economic Emergency Law through December 2007
--Tensions rise between GoA and health insurers over proposed 2007 fee increases
--GoA announces intention to terminate "Price Agreements" at the end of 2007
--Argentina's September trade surplus is $895 million, in line with market expectations
--BCRA forecasts low inflation, record GDP growth, and lower unemployment
--Argentina to import electricity from Brazil during high-demand peaks expected late-2006
--GoA will not increase penalties on households that fail to reduce energy consumption
--Oil production in Argentina expected to decrease by 17% between 2007 and 2009
--Commentary of the week: When the Lights Are On and the Economy Is Off

Buenos Aires Province successfully launches $475 million bond issue
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¶2. On October 25, the Province of Buenos Aires successfully issued $475 million in 12-year bonds. The Province received $1.2 billion in bids for its original issuance of $300 million (four times oversubscribed), prompting it to increase

the amount to $475 million (the maximum amount allowed by the provincial congress). The bond was priced to yield 9.75% or a spread of 492 basis points over comparable maturity U.S. Treasury securities, and it immediately tightened to 9.57% in the secondary market. Merrill Lynch was the lead-manager of the transaction. (Note: Similar to the federal government, B.A. Province defaulted on its debt following the 2001/2 financial crisis. In December 2005, the Province restructured the majority of the $3 billion in private sector bonds it had defaulted on at 45 cents on the dollar. The Province achieved a 93% acceptance rate from bondholders versus 76% in the federal government's March 2005 debt exchange. End Note). The Province plans to use the proceeds to make debt payments and fund capital expenditures. S&P has assigned its speculative grade single-B-plus rating to the province, the same as Argentina's sovereign rating, with a stable outlook. Moody's has assigned ratings of B3 to the offering, also the same as its sovereign rating for the country but two notches below S&P's.

Argentine Congress may extend Economic Emergency Law through December 2007
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¶3. Argentine Senator Capitanich stated on October 20 that Congress is considering xtending the Economic Emergency law, due to expire December 31, 2006, for one year. Congress first approved the Economic Emergency Law in 2002 following Argentina's economic and financial crisis, and has since extended it on an annual basis. This law delegates legislative powers to the executive branch and allows the President to enact a wide range of economic policies by decree (e.g. debt and utility tariff renegotiations). Even though the economy is growing rapidly for the fourth consecutive year, the GoA argues that the extension of the Emergency Law is necessary to allow the country to defend itself in lawsuits filed by holdouts from the 2005 debt

exchange. Additionally, the GoA says it needs the extension to facilitate renegotiation of contracts with private utility companies.

Tension rises between the GoA and health insurers over 2007 fee increases
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¶4. On October the 23, health insurers announced that they will increase fees by 18-23%, effective January 2007, in order to cover rising costs, including a 19% salary increase for the sector's workers. (Note: this fee increase will impact three million private health insurance subscribers.). Economic Minister Miceli responded on October 24 that the GoA would not allow "irresponsible" price hikes and reassured the public that the GoA would use "whatever means" it has to prevent them. Furthermore, Miceli reiterated that the GoA will continue its price control regime for as long as necessary. In a more conciliatory move, Miceli said the GoA would review the health sector's cost structure to determine whether some level of fee increase might be justified. Local analysts estimate that the 18-23% fee increase would result in a 0.8% m-o-m increase in the January CPI.

GoA announces intention to terminate "Price Agreements" at the end of 2007

¶5. GoA officials and executives of major food companies met October 25 and verbally agreed to maintain current food prices through December 2007. Following the meeting, Secretary of Internal Trade Guillermo Moreno stated that

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President Kirchner envisions ending all price control agreements at the end of 2007, whereupon it would allow market forces to determine prices. Local media reports on this announcement report that local private sector players are skeptical that the GoA would end price controls without

an extended phase-out period.

Argentina's September trade surplus is $895 million, in line with market expectations
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¶6. The September trade surplus reached $895 million, in line with market expectations. Exports increased 17% y-o-y to $4.0 billion, following 12% y-o-y growth in August, with increases in both price (6% y-o-y) and quantity (11% y-o-y). Exports were driven by increases in industrial goods (35% y-o-y), agribusiness (20% y-o-y) and primary goods (15% y-o-y), while fuel and energy exports decreased 12% y-o-y. Imports increased 28% y-o-y to $3.2 billion, with increases in both price (5%) and, especially, in quantity (22%). Imports were driven by increases in fuel and oil (67% y-o-y), intermediate goods (31% y-o-y), capital goods (30% y-o-y), parts for capital goods (22% y-o-y) and consumer goods (17% y-o-y). The accumulated trade surplus reached $9.1 billion for the first nine months of 2006. The BCRA consensus survey expects the 2006 annual trade surplus to narrow to $10.8 billion by the end of the year, compared with a $11.3 billion trade surplus in 2005.

BCRA forecasts low inflation, record GDP growth, and lower unemployment in 2006
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¶7. In its latest Inflation Report, issued October 23, the BCRA forecasted 2006 inflation between 8% and 11%, in line with the Monetary Program, and estimated that prices will show a similar performance in 2007. The BCRA noted that inflationary expectations -- measured by the BCRA consensus survey -- had fallen. The median forecast for year-end inflation stood at 9.8% in the September's survey, down from 11.4% in June and from 13% in January. According to September's survey, the consensus estimate for 2007 inflation is 10.5%.

¶8. The BCRA report also highlighted the strength of the

economy and forecast that real GDP growth will exceed 8% in 2006, with total GDP 16% higher than the record achieved in ¶1998. The BCRA also estimates that the unemployment rate will fall to 9% by year-end, and the primary fiscal surplus will be 3.3% of GDP for 2006 (Note: this is lower than reported in the October 20 E&F Weekly, which stated that at current trends the GoA's primary fiscal surplus will reach 4% of GDP for 2006, compared to the budget's 3% forecast.)

Argentina to import electricity from Brazil during high-demand peaks expected late 2006
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¶9. The GoA announced plans to import electricity from Brazil during the demand peak expected for the end of 2006. This measure seeks to alleviate expected energy shortages, which are the result of the combination of strong demand for energy (due to expected higher than normal temperatures) and lower supply generated by technical failures at four energy generators. CAMMESA (the wholesale electricity market administrator) separately asked electricity generators to postpone maintenance-related stoppages and shut-downs until after December, when electricity demand is expected to decline.

GoA will not increase penalties on households that fail to reduce energy consumption
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¶10. During an Industrial conference on October 20, Energy Undersecretary Folgar stated that the GoA will not accede to energy company calls for it to increase penalties (beyond current levels) on households that are not reducing their energy consumption. Folgar argued that the existing penalty fee structure is adequate and that the incentives under the government's current energy savings program are working to

reduce consumption. (Note: In May 2005, the GoA introduced a plan to induce residential users to save energy. In order to avoid a government-imposed fine, residential users must reduce energy consumption relative to the previous year's level. Energy companies have advocated for increasing this fine to add further incentive for reducing consumption, and thus alleviate the expected energy shortages.) Folgar also denied that the GoA will provide subsidies to industries that generate their own electricity.

Oil production in Argentina expected to decrease by 17% between 2007 and 2009
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¶11. According to a report elaborated by thirty oil companies in Argentina, local oil production will decrease 17% between 2007 and 2009 due to the natural drying up of existing oil wells and the lack of investment in exploration (largely a response to GoA taxes on oil exports, which are designed to maintain low domestic prices). Local oil production has already decreased 5% in 2005 and 3.2% in the first semester of 2006. Meanwhile, there is surging demand for fuel, driven by high GDP growth (e.g. the demand of gasoline increased 18% in the first semester of 2006). As a consequence, oil exports decreased 59% y-o-y in the first six months of 2006. At this rate, Argentina may go from being an oil exporter to an oil importer in the next two years.

Commentary: When the Lights Are On and the Economy Is Off
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¶12. In order to avoid an electoral stumble, the government is concerned about providing electrical power to heavy residential users in the short term. However, the impact on the industrial sector may end up affecting the economic growth rate.

¶13. The government denies the existence of a (energy) crisis based on a simple fact: the massive foretold blackouts have not occurred. It is trying to avoid any blackouts in the Federal Capital and Buenos Aires suburbs, where the majority of residential users and voters live. The political objective to keep residential users subsidized and protected from power outages is at odds with the necessity, also political, to maintain a high economic growth rate.

¶14. The government's main concern is to reduce power outages during the (austral) summer season. Electrical generation is currently at maximum capacity, and is at risk, as technical studies from CAMMESA (wholesale electricity market administrator) anticipated. The largest consumers of electricity, accounting for approximately 30% of total demand, will have to satisfy their additional demand for electricity from outside the system (either they self generate it or purchase it from other producers). If the demand peak surpasses 18.000 MW, large users will not only have to search for additional supply, but will also have to move their demand off peak.

¶15. The industrialists are worried about long run results and are thus increasingly concerned about the energy shortage. They have, therefore, begun to dust old generating equipment, buy new equipment, or rent it from other companies, in order to provide themselves with additional energy. In today's market the international wholesale price per MW for industry is $35. However, companies using rented equipment to generate their own electricity, using diesel oil, face prices five times higher. This solution, anyway, is temporary, just to get through the summer. If the company is to maintain its growth, it must take measures to assure long term energy supply. This is where the other part of the energy problem begins. If a power generation company is to sign a contract to provide the needed extra energy output, it must purchase additional gas from a gas producer. As the supply of gas is stagnant, and gas reserves are in sharp decline, it is impossible to get new contracts for additional

gas.

¶16. The government's plan does not take into account all these aspects. The same industrialist who started seeking additional electricity to maintain his growth is having his legs cut out from under him by the gas supply. With less natural gas for industrial activity (until more comes from Bolivia or the LNG (liquid natural gas) plant is constructed), users must shift to other more expensive fuels, such as diesel, which are also limited. As the country loses its petroleum self sufficiency, the local price for oil (until now capped by a mixture of government policy and moral suasion) is also beginning to pressure on the up side. As a consequence, prospective investors (in Argentina) face an expensive and uncertain energy supply.

¶17. Investment is required for the government to maintain its high-growth strategy. The need to keep the lights on for most voters conflicts with the need to maintain economic expansion. Energy supply is a short term hostage. If there is no investment to increase the energy supply, the economy risks faltering. Paradoxically, if economic growth slows, there will less need for the extra energy. The energy issue will say goodbye to newspaper headlines when the country overcomes this dilemma: when there is enough energy for both keeping the lights on and sustaining the economy's takeoff. (Note: By Daniel Montamat; translated from an editorial published in Cronista on October 19. We reproduce selected articles by local experts for the benefit of our readers. The opinions expressed are those of the authors, not of the Embassy. End Note.)
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